

**STATEMENT
OF
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**(ATTACHMENT TO COMMENTS AND PETITION FOR
RULEMAKING OF THE NATIONAL CABLE &
TELECOMMUNICATION ASSOCIATION)**

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1. INTRODUCTION AND BACKGROUND

My name is Howard Shelanski. My current position is Acting Professor of Law at the University of California at Berkeley. I received my B.A. from Haverford College in 1986, my J.D. from the University of California at Berkeley in 1992, and my Ph.D. in economics from the University of California at Berkeley in 1993. I have been a member of the Berkeley faculty since 1997. In 1998-2000 I was on leave from my faculty position to serve as a Senior Economist to the President's Council of Economic Advisers (1998-99) and then as Chief Economist of the Federal Communications Commission (1999-2000). I rejoined the Berkeley faculty on a full time basis in July 2000. I formerly practiced law in Washington, D.C. with the firm of Kellogg, Huber, Hansen, Todd and Evans and served as a law clerk to Justice Antonin Scalia of the U.S. Supreme Court.

I teach and conduct research in the areas of telecommunications regulation, antitrust, and applied microeconomics. My recent publications include articles in the *Journal of Law, Economics and Organization*, the *Yale Journal on Regulation*, the *University of Chicago Law Review*, the *Journal of Law and Economics*, the *University of Chicago Legal Forum*, and the *Columbia Law Review*. I am co-author of the recently published legal textbook *Telecommunications Law and Policy* (Carolina Academic Press, 2001). I am a regular participant in academic conferences related to telecommunications policy and antitrust and lecture regularly on both topics at universities in the United States and abroad. My C.V. is provided as Attachment A.

This paper examines the economic incentives of cable operators in their procurement of programming to distribute in today's competitive market for retail video entertainment. The conclusion of this paper is that cable operators have every incentive to ensure a sustained and growing supply of diverse, high-quality programming to offer their subscribers. It is highly unlikely that any cable company, no matter how big, would or could act in a manner that systematically impairs the flow of programming to consumers. Nor is there any reason to believe that two or more cable operators would collude to act in such a manner.

The maturity of the cable business is such that subscriber growth is becoming harder to generate and is dependent on increasing the range and quality of program offerings to subscribers. Even more importantly, multichannel video programming distributors ("MVPDs") face increasing competition in attracting viewers and an expansion in their own demand for programming as a result of increased channel capacity. Both of these forces make it highly unlikely that a cable operator would, regardless of its ability to do so, have incentive to suppress the quantity or quality of programming that would otherwise be available and attractive to consumers. Largely for this reason, the FCC should not adopt a stringent, prophylactic limitation on the size of cable systems. Such rules are not costless, and because the need for them can be shown to be remote, the Commission should instead adopt a permissive rule and leave the unlikely events of harmful conduct to be addressed on a case-by-case basis.

This paper does not take a position on a specific level at which horizontal ownership should be capped, nor does it advocate any particular policy alternative from among those proposed in the FCC's pending FNPRM. The purpose here is instead to analyze the underlying case for any *per se* regulatory limit on cable ownership and to explain why that case is quite weak in the current competitive environment in which MVPD providers operate.

II. The Economic Incentives of Cable Operators

A. Changes in MVPD Competition Provide Incentives for Cable Operators to Avoid Harming the Programming Market.

To understand the economic incentives of cable operators, it is essential first to understand the market environment in which they currently provide services to consumers. Since the mid-1990's, three fundamental changes have come to the market in which cable firms operate. The first is the arrival of significant competition from DBS providers. The second change is the substantial increase in channel capacity. And the third change is the reduction in integration between program production and distribution and the growth of a more independent and powerful programming market. Each of these changed circumstances influences both how cable operators behave towards consumers and how they act toward program suppliers.

1. Effects of Competition.

Consider, first, the development of competition from DBS providers. From 1996 to 2001, the share of MVPD subscriptions held by DBS operators has increased from nothing to approximately 20 percent. This increase is particularly dramatic from the standpoint of cable operators because during that period DBS gained the vast majority of new MVPD customers and also took customers that had previously been cable subscribers. Large cable systems were struggling even to keep the subscribers they had, never mind achieving growth. Cable operators responded to DBS by offering expanded package options to subscribers, adding services like high-speed Internet access, and by upgrading their systems to match the high, digital capacity of the DBS operators. Indeed, the average number of programming services available to cable subscribers increased from 40 in 1996 to over 100 in 2001 on systems offering digital tiers. Importantly, given the congressional concerns about the programming market that motivated §

613(f), the increasingly competitive environment of the retail video market has sharpened the incentives of cable operators to seek out and provide the best programming they can to consumers. If they do not, consumers will subscribe to DBS, which has similar incentives to compete for customers on the basis of programming. Cable providers have long had reason to increase the appeal of their offerings in order to grow their subscriber base and to pull viewers away from conventional television and video rentals. But the successful entry of DBS into the MVPD business has made those incentives stronger by orders of magnitude. Not only is DBS a more perfect substitute for cable than is either broadcast or video rental, but it also initially marked an improvement over cable in terms of channel capacity.

Because cable operators face competition to attract subscribers, they must ensure that they have access to a steady supply of diverse and high-quality programming to offer consumers. Competition at the retail level of MVPD services thus influences behavior by cable operators upstream at the program procurement level of the business. And a cable firm's incentives at that level of the market will not be to harm suppliers of content, but rather to ensure that they are in the position to meet increasing consumer expectations about the variety and quality of programming they receive. There is little incentive in the current, competitive MVPD environment for a cable operator, no matter how large, to suppress the quantity or quality of programming that would be attractive to its subscribers. Inferior programming would impoverish the cable operator's offerings to subscribers and, in turn, cause the cable operator to lose further ground to DBS rivals.

The fact that cable operators and their competitors purchase much of the same programming raises the prospect that a sufficiently large cable operator could use its purchasing power to suppress prices and output without incurring a competitive disadvantage. If cable

monopsony leads to poorer programming choices for all retail video providers, then DBS operators would be constrained to show their viewers the same poor programming available through cable. There are several reasons, however, why a large cable operator would be very unlikely to have either the incentive or the ability to exercise monopsony power in this way.

First, consumers accustomed to receiving a certain level of choice and quality in their cable channels might be reluctant to accept a decline in those features, so even a cable operator that did not face much competition could face loss of subscribers. Indeed, some cable channels may be so important to consumers that failure to offer them might drive subscribers away from cable even in the absence of competitive alternatives like DBS.

Second, to the extent that consumers are price sensitive in their purchases of cable service, a cable operator will have to adjust prices downward as the quality and diversity of the programming it distributes decline. It might save some programming costs in doing so, but it will also lose some subscription revenues. A cable operator might find it in its interest to make this tradeoff up to a point, but the tradeoff limits the extent to which monopsony power would be used to weaken programming.

(a) *Competition for MVPD subscribers eliminates both monopoly and monopsony.*

The discussion above makes clear that any regulatory implementation of § 613(f) needs to take into account the relationship between monopoly power in retail MVPD services and monopsony power in the “wholesale” program market. Without monopoly power in the distribution of programming, a cable operator has diminished ability and incentive to exercise monopsony power in a manner that adversely affects the flow of programming to consumers.

The more MVPD firms there are to bid competitively for given programming, the less able is any individual firm to force a low price on the program producer. This is the case even if the MVPD operators do not compete head-to-head for retail subscribers. A program producer may be able to forego a deal with, say, a cable operator in Chicago if it knows it can strike a deal it likes with cable operators in St. Louis and New York.

But the program producer in the example above is in an even stronger position when, as now, it has a potential alternative customer in the Chicago market itself. It is one thing for the incumbent Chicago cable operator to refuse to carry particular programming when there is no one else in its market to carry that programming either. It is quite a different matter for the cable operator to drive a hard bargain with content producers when it faces retail competition and, therefore, can less credibly threaten not to carry desirable programming if the producer refuses to reduce prices to the level the cable operator wants. And when the competitor challenges the cable operator not only in a particular local market, but also in every market in which the cable carrier offers service, then that cable operator's ability to act monopsonistically is yet weaker. But DBS competition changes not only the ability, but also the incentive to suppress prices in a manner that adversely affects the flow of programming. An operator with monopoly power in the retail market and monopsony power in the wholesale market might conceivably be able to foist reduced quality on its customers and therefore profit by extracting artificially low prices for programming. But that ability is significantly diminished once those consumers have alternatives, as they now do in choosing MVPD providers.

(b) Program procurement as a competitive strategy.

To be sure, competition between cable and DBS could lead an operator of one platform or the other to seek agreements with programmers that provide it with a market advantage. An

operator might, for example, seek an exclusive deal with a program producer. But in today's marketplace, in which DBS operators are large and well established, such strategies are likely to be means by which rival platforms compete and are very unlikely to serve as predatory tactics to eliminate competition.

Moreover, it is unlikely that any limitation on the size of a cable operator is necessary to ensure that exclusive dealing or other procurement strategies are used pro-competitively rather than for predatory purposes. The 18 percent (and growing) market share held by DBS providers means they have great power to procure and induce production of programming they need. If a large cable company prevented its DBS rivals from obtaining certain programming, for example, it would probably accomplish little but to create competition at the programming level to fill the vacuum.

2. Effects of increased channel capacity.

Increased channel capacity in cable has been driven by a number of forces. Digital technology has made it possible for cable operators to provide subscribers with more than 100 channels in a variety of packages. The need to provide desirable programming on this expanded range of channels has two effects on the considerations at issue for the FCC under section 613(f).

First, just as competition to attract subscribers has sharpened the cable operators' demand for quality programming, increased channel capacity has expanded the amount of such quality programming that cable operators need to purchase. This in turn adds to the incentives of the cable operators to ensure that the programming market is a strong and diverse one. With additional capacity on its system, an operator can offer highly diverse, niche programming to attract audiences that previously, because of capacity constraints, could not be reached.

Second, even without competition, and even if there were only one large cable carrier,

that cable company would want to air programming of sufficient desirability to grow the market for cable services and shift demand for such services to a higher level. Consumers continue to have the options of renting videos or watching conventional broadcast television and both alternatives have long placed some pressure on cable providers. Thus, both on its own but particularly in conjunction with competition, increased channel capacity provides MVPD operators with incentives to foster rather than harm the market for program production.

3. Dis-integration of program production and distribution.

As mentioned, there has been a reduction in recent years in the proportion of program production that is owned by cable operators. This change directly reduces the extent to which cable operators could diminish the amount and diversity of programming being offered on the market by discriminating in favor of programming that they own. Moreover, the reduced integration of program production and distribution also reduces the ability of cable operators to dictate the terms of their procurement agreements with independent program producers. With reduced resort to vertically integrated programming as an alternative to independently produced fare, the more essential the independent producers are to the success of cable and the better is their bargaining position with respect to the cable operators.

4. The link between incentive and ability to exercise monopsony power is broken.

The analysis so far essentially shows that both the incentive and ability for a cable operator to inflict harm through monopsonistic behavior have been reduced through increased competition in the video market. And in those circumstances where either incentive or ability to exercise buying power does exist, the two will not exist together. Even if competition leaves a large cable operator with some leverage over a program producer, the cable carrier will have no

incentive to reduce the programmer's production of quality content. And even if DBS competition might create incentives for cable operators to deprive rivals of access to certain programs or to discriminate in favor of particular program producers, that same competition deprives cable operators of the ability to implement such strategies.

B. Cable Operators Have Little if Any Incentive to Collude for Anticompetitive Purposes.

The Commission's previous limit on horizontal ownership was designed to ensure that even if two cable operators collusively declined to carry a program network, such collusion would not deprive the network of the potential to reach enough subscribers to be viable. To once again incorporate an assumption of collusion into the regulatory analysis at issue would almost certainly put too stringent a cap on horizontal ownership because it is unlikely that such collusion would occur.

One could conjecture that two cable operators might join together to purchase programming and thereby get better terms from the program supplier with the threat that failure to comply with the cable operators' demands would result in the programmer's loss of access to both of the colluding cable systems. This strategy would raise two potential concerns, both of which are implicit in section 613(f). The first concern is that the terms demanded by the colluding cable systems would be so stringent as to reduce the ability of the programmer to produce quality programming. The second is that failure of the programmer to comply would lead to a loss to subscribers due to a reduction in the diversity of programming on the cable system. Both of these harmful outcomes are, however, most unlikely.

For cable operators to collude in the procurement of programming to the point that program production was harmed would be self-defeating and against the interests of the

colluding parties. The colluding cable operators would have to predict that their benefits from reduced payments to the programmer would be greater than their losses from subscribers dissatisfied with receiving the degraded offerings of weakened program producers. For only then cable operators have incentive to conspire to exercise monopsony power to the degree that program production was harmed. That tradeoff becomes increasingly unlikely as subscriber growth rates diminish and especially as competition from other MVPD providers like DBS operators increases. Only if the colluding parties have captive customers with relatively inelastic demand for cable services is the tradeoff between program cost and program quality likely to be a generally profitable one. Those conditions do not hold in today's market for video entertainment.

In any event, even if there could conceivably be isolated instances in which cable operators colluded in a way that harmed program quality and diversity, this would hardly justify a stringent horizontal ownership limitation.. Before a strong prophylactic ownership rule is put in place just to eliminate the possibility of collusion, the relevant policy question is whether cable operators would rationally act to harm the programming market in a frequent or systematic way. For the reasons discussed earlier in this paper, the answer to that question is no. Such actions would be directly contrary to the rational, competitive incentives of the cable operators. The important consideration under section 613 is whether cable operators would have incentive to behave in a way that harms the program market as a whole. In today's competitive environment, the likelihood of such irrational behavior is remote. The focus should be on the programming market, not on the possible effects on any individual programmer.

The above discussion has assumed for the sake of argument that cable operators might find a reason to collude in program procurement, and tried to show that such collusion would not

be intended to harm the programming market. But it is important to note that the incentive to collude in the first place cannot merely be assumed. Cable operators trying to keep customers in their territories from dropping their subscriptions or from subscribing to DBS competitors will want to make what, in their judgments, are the best programming decisions for their audience. The differing needs of different cable operators and the fact that many will already have the scale necessary to procure programming efficiently weigh against any incentive to collude in the first place. Moreover, collusive arrangements entail bargaining and transaction costs of their own that may make them undesirable or untenable.

One could also conjure up the specter of collusion between cable operators and their DBS rivals, although such arrangements are even less likely than collusion among cable operators. The incentives to cheat on a collusive scheme would be much more powerful where the parties were rivals in the distribution market. At most, the rival MVPD operators might have incentive to join in bargaining with a limited number of powerful programmers, but even there the likelihood of collusion is slim. No operator would ultimately give up carriage of highly desired programming if such carriage would afford it an advantage in attracting subscribers. Moreover any such scheme would likely attract antitrust scrutiny, possible for denial of access to essential facilities. Finally, any more comprehensive collusion between cable and DBS operators on the delivery of programming could well be punishable a conspiracy to restrict output, a *per se* violation of the antitrust laws.

Because incentives for operators to collude in the first place are unclear and arguably improbable, the FCC should not adopt a horizontal ownership cap with an eye to limiting the imagined market power of two firms working together. If collusion is presumed possible and thereby built into the cap, then the cap may be set too low. Instead, any cap should be set with an

eye towards limiting the market power of any *single* cable operator. Congress directed the FCC to take the possibility of collusion into account, not to presume it would occur. Given the unlikelihood of concerted anticompetitive behavior by MSOs towards program producers, the FCC should not set the cap at a level that anticipates that very collusion.

C. Expanded Horizontal Ownership May be Beneficial.

A prophylactic rule limiting horizontal ownership would not be costless. Indeed, the Commission itself has recognized that economies of scale may be realized through consolidation that benefit not only cable operators and consumers, but programmers as well. The ability to negotiate larger agreements with fewer carriers may allow a programmer to reach a critical mass of viewers with greatly reduced transaction costs. But the true benefits of consolidation are more likely to arise elsewhere. This is particularly the case when enormous investment is being made to upgrade cable networks to higher capacity, two-way systems that can both deliver more channels and allow consumers to send and receive data at high speeds. To the extent there are scale and scope economies in engineering, equipment procurement, and deployment of technical personnel, there may be good reasons for cable systems to expand their size.

To counsel against a strict, regulatory limit on ownership, one need not conclude that the efficiencies from cable consolidation will always or even often result. Any merger will need to pass muster under the antitrust laws as well as under the Commission's license transfer regulations. Those proceedings provide the appropriate forum for case-by-case assessment of efficiencies and public benefits and how they fit into a balance with any potential harms from the transaction. But so long as it is the case that those efficiencies *may* exist, then any prophylactic limit on cable horizontal ownership must be recognized to have potential costs. With that recognition it becomes essential to balance the potential for benefits from

consolidation against the potential harms to the programming market implicit in section 613. The benefits of horizontal ownership may indeed be speculative and variable from case-to-case. But as this paper has argued, the incentives of cable operators either individually or collusively to act in a way that harms the programming market are truly remote. That balance itself weighs strongly against any prescriptive ownership prohibition and in favor of the most permissive rule the Commission can promulgate consistent with Congress' mandate.

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Current Position

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Acting Professor of Law. Teaching areas include antitrust law, telecommunications law, regulated industries, and contract law.

Experience

Federal Communications Commission, Washington, D.C.

Chief Economist. 1999-2000.

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Associate, telecommunications and general litigation practice, 1995-97.

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Law Clerk to Judge Louis H. Pollak, U.S. District Court, Eastern
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Law Clerk to Judge Stephen F. Williams, United States Court of
Appeals, D.C. Circuit, 1992-93.

**Research &
Publications**

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